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IN THE
Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of California for the First Appellate District

BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE AMICUS CURIAE

The Committee On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 550 multistate corporations involved in interstate and international commerce.

COST submits this brief and believes this Court ought to grant certiorari because of California's inconsistent and incorrect application of the law; California's inability to decide upon a standard by which to apply the law; and, most importantly, because the issues presented by the instant case are currently being litigated in courts throughout the country without a clear, well-articulated touchstone regarding unitary theory. California courts have vacillated twice on the answer to this issue and have applied the result inconsistently to California taxpayers. The issue in this case is whether destination sales of a non-nexus affiliate may constitutionally be included in the numerator of the California apportionment factor. For 22 years, the standard in California (as stated in *Joyce*) was that non-nexus company receipts were not added into the "numerator." *Appeal of Joyce, Inc.*, No. 66-SBE-069 (Cal. St. Bd. of Equal., Nov. 23, 1966). *Finnegan II*[2]

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

[2] The decision is popularly known as *Finnegan II*. It was the opinion on rehearing from *Finnegan I*, 88-SBE-022 (Cal. St. Bd. of Equal., Aug.

repudiated the *Joyce* rule, thereby excluding the sales from the numerator, and remained the law for 9 years from 1990 to 1999. *Appeal of Finnegan Corp.*, No. 88-SBE-022-A (Cal. St. Bd. of Equal., Jan. 24, 1990). (*Finnegan* was formally adopted by California in Notice 90-3, dated June 8, 1990). Changing its mind again, the court in *Huffy* overturned *Finnegan*, restoring California to the old *Joyce* regime. *Appeal of Huffy Corp.*, No. 99-SBE-005-A (Cal. St. Bd. of Equal., Sept. 1, 1999).

This oscillation is exacerbated by the fashion in which California has implemented each change in position. The State applied *Finnegan* retroactively to taxpayers—but when *Huffy* was decided California chose to apply the reversal of position prospectively.[3] All of this occurred with *no* change in the underlying statute. It is this facet of the problem that has created the tax liability at issue in the instant case.[4] There is a need for a standard of uniformity in California. There is also a concomitant need for such a standard throughout the United States. Four other states currently follow *Finnegan*: Arizona, Indiana, Kansas and Utah.[5] New York is currently in litigation over which standard to apply. Many states,

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28, 1988), whose facts were the mirror-image of *Joyce*. It was not until 1990 that the SBE specifically overruled *Joyce*, although its logical underpinnings were unmoored by the SBE's 1988 decision.

[3] *Compare Appeal of Wynn's International*, No. 98R-0857 (Cal. St. Bd. of Equal., Sept. 1, 1999) and *Appeal of Nutrasweet Corp.*, No. 92-SBE-024 (Cal. St. Bd. of Equal., Oct. 29, 1992) (both applying *Finnegan* retroactively) *with Huffy* (stating that the return to *Joyce* applies only for tax years beginning on or after April 22, 1999).

[4] California assessed Citicorp using the *Finnegan* rule for years prior to the *Huffy* change in position.

[5] *Airborne Navigation Corp. v. Arizona Dept. of Rev.*, No. 395-85-I (Ariz. Bd. of Tax Appeals, Feb. 5 1987); Ind. Dept. of Rev. Information Bulletin No. 12, (Sept. 1 1988); Kan. Dept. of Rev. Ruling No. 12-91-1 (Feb. 1, 1991); Utah Reg., Rule R865-6F-24 (Nov. 24, 1993).

including Alaska, Colorado, Illinois, and Maine, have taken the position that *Joyce* is the proper standard.[6] Hence, there is not only a patent split of authority among the states but also the potential for repeated appeals through those court systems and ultimately before this Court. The granting of certiorari by this Court would resolve the current ambiguity and would provide judicial economy by foreclosing numerous possible future appeals.

SUMMARY OF THE ARGUMENT

COST asks this Court to accept the case and determine that California violated the Due Process and Commerce Clauses of the United States Constitution by taxing an entity with no constitutional nexus with the state. The inclusion of Petitioner's affiliate's California destination sales into both the numerator of California's apportionment factor and the apportionable tax base makes the end result the same as if California had subjected Petitioner's affiliate to income tax in the first place. The fact that Petitioner's affiliate is part of a unitary group subject to tax in California is relevant to whether the affiliate's income is included in the taxable base, but it does not support including the affiliate's sales in the numerator of the apportionment factor.

The unitary business principle is strictly a theory of apportionment. It was not meant to be a blanket rule of jurisdiction to tax. The fact that an entity is unitary with a group of entities does not, *a fortiori*, render the entity taxable in each state where the group has nexus. To reach such a conclusion is to transmute *unitary* theory into *nexus* theory. Stated alternatively, it is possible to have a unitary group

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[6] *In the Matter of Taxpayer Corp.*, No. 90-027 (Alaska Dept. of Rev., Sept. 17, 1990); Colo. Dept. of Rev. Bulletin No. 92-10 (July 1992); *Dover Corp. v. Illinois Dept. of Rev.*, 648 N.E.2d 1089 (Ill. App. Ct. 1995); *Great Northern Nekossa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996).

where not all members have nexus with the taxing state. That is the situation in the instant case. In such a scenario, the proper logic is that *all* business income of the unitary group forms the apportionable tax base. However, all of that income is not automatically part of California's apportionment numerator used to form the portion to which California is entitled. Only those members of the unitary group who have proper Constitutional nexus with California have their factors included in California's numerator. To conclude otherwise renders the nexus concept nugatory as applied to a unitary group.

A clear example of California's use of unitary measurement as a replacement for nexus theory is useful. Assume the existence of three affiliated corporations, One, Two and Three, with daily operations so intertwined that they cannot be parsed out for tax purposes. California deems the three corporations a unitary group. Under this large umbrella, all business income of the group, as defined by UDITPA,[7] is to be apportioned based on the standard formula. The denominator of the formula, hence, includes the total sales generated by all three corporations. However, if only One and Two have nexus with California, then the numerator is only the sales of One and Two. Since Three has no nexus, it is not part of the numerator, only the denominator. Placing Three's California-sourced sales into the numerator, is the same as taxing Three in the first place, which violates Constitutional nexus safeguards. To eliminate Three's income from both the numerator and denominator results in Three's sales being apportioned based *only on* One

[7] UDITPA, the Uniform Division of Income for Tax Purposes Act, provides definitions of business and nonbusiness income and rules for the apportionment and allocation of income. Income is determined to be business income if it meets UDITPA's transactional or functional test and is then subject to apportionment. Income which is outside UDITPA's test is non-business income and is allocated in whole to one state, not divided per formulary apportionment.

and Two's factors. The only formulation that preserves unitary theory is to place Three's sales only in the denominator.

ARGUMENT

I. CALIFORNIA'S IMPROPER APPLICATION OF THE UNITARY BUSINESS PRINCIPLE RESULTS IN THE TAXATION OF CORPORATIONS OVER WHICH CALIFORNIA HAS NO CONSTITUTIONAL JURISDICTION.

Ostensibly the inquiry in this case need not go beyond the admission of the State of California that the tax rule complained of in this case has the result of taxing an entity that did not have nexus with the State. *See Huffy*. In considering its abandonment of the *Finnegan* rule, which the State would impose on the taxpayer in this case, the State Board of Equalization stated, "while there was hope that the *[Finnigan]* apportionment rule would lead to a truer application of the unitary concept, the actual practice has resulted in the taxation of corporations which would not otherwise be taxed as they have no tax nexus with the State of California." Id. (emphasis added). Your *amicus* realizes that confessed violations of the Due Process and Commerce Clauses of the United States Constitution alone may not be sufficient to warrant this Court's exercise of its discretion to decide this case, but that coupled with the continued use of the unconstitutional rule by other states is a compelling consideration.

1. The Unitary Business Principle, as articulated by this Court, is an application of the Due Process and Commerce Clauses' fair apportionment standards and thus cannot work to subject an entity to tax that does not otherwise have nexus.

This Court's approval of the unitary business principle is a recognition that under certain circumstances the business

activities of a commonly-owned and controlled group of entities may be so inextricably wound that the value or income of each of the entities may be more fairly measured as a part of their total income.[8] So the law allows tax jurisdictions to use the hypothetical construct of a unitary business to determine the overall scope of the economic enterprise that is to have its value or income measured for the purpose of assigning a portion to the state. The Court has set the guidelines for this determination in terms of centralized management, functional integration and economies of scale. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). The focus of the inquiry is on how a business operates within itself.

To prevent multiple and extraterritorial taxation, a taxpayer has a constitutional right to a division of the tax base between those states where the taxpayer is subject to jurisdiction. *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952). UDITPA was enacted by California and other states to promote uniformity among the states in how they divide the tax base. UDITPA § 19. CAL. REV. & TAX CODE §§ 25120–25139. The part of the total income that is assigned to an entity in a particular jurisdiction is determined by formula apportionment. That is, the factors of business activity that generate the value or income in each of the jurisdictions in which it does business are measured and the value or income of the business is assigned to those jurisdictions in proportion to the factors that exist in those jurisdictions. So, for example, a typical manufacturing business may have its income apportioned by use of the three-factor formula of payroll, property and sales; a pipeline company may have its income apportioned in accord with a barrel-miles formula; and a shipping company may have its income assigned by use of a ton-miles formula. The particulars may vary from one

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[8] *See Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891); *Western Union Tel. Co. v. Taggart*, 163 U.S. 1 (1896).

type of business to the other, but this is essentially a measuring exercise.

The apportionment formula used in California is a standard,[9] three-factor formula of payroll, property and sales.[10] The kernel issue before this Court is exactly what constitutes the proper numerator in the sales factor. *Finnegan* and the California lower courts would believe that the "sales within California" are all of those conducted by the entire unitary group. Petitioner and *amicus* contend that the "sales within California" can only include the sales of those members of the unitary group that have nexus with California.

Nexus principles dictate that a state can only exert income tax jurisdiction when it is constitutional to do so. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). Both Commerce Clause and Due Process Clause nexus must be met. U.S. CONST. art. I, § 8, cl .3; U.S. CONST. amend. XIV, § 1. Thus, any application of UDITPA formulary apportionment is bound by Constitutional nexus limitations. The unitary business principle (what is to be measured), and formula apportionment (how much of the thing measured is assigned to what entity in what jurisdiction), are tools of measurement. They are not determinative of who is taxable where. This last consideration, nexus, is determined on the basis of the amount and types of activity that an entity has within the taxing jurisdiction.

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[9] California double-weights the sales factor in computing the average. CAL. REV. & TAX CODE § 25128(a).

[10] This formula has been upheld as Constitutional. *See Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

2. The inclusion of the California-destination sales of the Petitioner's affiliate, which has no nexus with the state, in the numerator of California's receipts factor for purposes of apportioning Petitioner's income changes the Unitary Business Principle from a principle of measurement (apportionment) to one of jurisdiction (nexus).

The Petitioner is part of a unitary group that has activity in California. Within this unitary group are entities that have nexus with California and, in particular, one without nexus—the South Dakota affiliate, Citibank, S.D.[11] However, that same entity has sales receipts arising from transactions destined for California. There are three alternatives as to what should be done with the California sales of Citibank S.D. The first option is to include the sales in neither the numerator nor the denominator of the apportionment formula.[12] Alternatively, the income could be added to both the numerator and denominator. The third, and proper treatment is to place the California sales income into only the denominator of the formula, not the numerator.

The denominator relates to factors of production that created the total unitary group's income. *Cf. Adams Express Co. v. Ohio*, 165 U.S. 194, 221 (1897) (stating that the 'unit' being measured was one "of use and management."). The Unitary Business Principle grew from the railroad cases that treated the entire enterprise as a single "unit" of business. Applying this same methodology to the instant case, all business income by the Petitioner's unitary group is included as the units' total income and included in the denominator.

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[11] As stipulated by both Petitioner and Respondent. Joint Stipulation ("Stip") ¶ 19, Joint Appendix filed with the Cal. Ct. App. ("JA") p. JA 0099.

[12] Although not espoused by either party, this formulation is incorrect as it equates unity to nexus. The practical result is that the excision of the sales from the denominator turns the income into either allowable non-business income or says that Citibank S.D. is not part of the unitary group.

The numerator only relates to activity constitutionally related to the taxing state. *See* CAL. REV. & TAX CODE § 25134. Under Constitutional nexus rules, that activity cannot be unilaterally "sourced" to the state. There must be an underlying nexus between the taxing state and the entity that generated the activity taking place from sources within. *See Complete Auto Transit*, 430 U.S. at 277–79. The basis for establishing this connection is solely nexus theory, not unity. The Unitary Business Principle was never intended to be a proxy for substantial nexus. *Cf. Shell Oil Co. v. Iowa Dep't of Rev.*, 488 U.S. 19, 31 (1988) (stating "the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to in-state activities"). Moreover, to impute a connection based upon unity fails in practical application by overextending the tax authority of the State—the majority of states do not treat unity and nexus as equipollent systems.

The nostrum both *Finnegan* and Respondent proffer as the solution—the inclusion of the California sales in both the numerator and denominator—yields the same practical result as if Citibank S.D. had been taxed in its own right to begin with. Such a result contravenes the entire premise of nexus. It allows California to do indirectly what it otherwise is constitutionally prohibited from doing. *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 468 (2000). Within the unitary group, some members have nexus with California and some do not. If all members' sales income is included in the numerator, then the result is that each one is effectively treated as if it had nexus with California. The ramifications are such that each member of the unitary group can then be said to have nexus in each state where any one of the group's members has nexus. This formulation expands taxing authority beyond the bounds of traditional nexus principles by allowing a State to tax an entity that has no connection to the taxing state but for being unitary with another entity that does.

A simple example following the facts of this case illustrates the difference between measurement and nexus. A single corporation, A, doing business in South Dakota, may make sales into California. If A has all of its property and payroll in South Dakota and makes 30% of its sales to California destinations, the typical three-factor formula would assign 10% of A's sales to California.[13] However, A may not have sufficient contacts with California that California may tax the income of A. If the South Dakota corporation present in this case were not a part of a unitary group of corporations it is agreed that there would be no tax due from it.

In the case before the Court, the South Dakota corporation, ("A" for convenience), is a member of a unitary group of corporations. Should that change the result? California concedes that A is not taxable in California, but would use A's sales nevertheless to attract tax to California.

The correct solution is that the California sales of Citibank S.D. are properly includible in the denominator but should not be part of the numerator. The numerator, as it represents the activity within California of the taxpayer, can only be that activity that has nexus between California and the taxpayer. *Complete Auto,* 430 U.S. at 277. The criticism of the *Joyce/Huffy* standard is that it allows for corporate form to prevail over economic substance, given that a different result is reached if corporate divisions, rather than separate entities are used.[14] The countervailing problem is that the *Finnegan* standard requires mutating the Unitary Business Principle into one of nexus and, at the same time, overriding the United States Constitution's constraints on the power of California to impose corporate income taxes. The better reasoned

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[13] Calculated as follows: (0/100 + 0/100 + 30/100 = 30/300 = 10%).

[14] But this criticism is inadequate. *Amicus* and Petitioner believe that a slight asymmetry between form and substance is preferable to an unconstitutional application of unitary theory.

resolution is to reverse the California Court of Appeals and find that California sales income can only include those members of the unitary group which have actual nexus with the state.

CONCLUSION

For the reasons stated above, and because this critical issue is spreading to other states, COST respectfully requests the Court to accept this case for review, reverse the decision below and order a refund of the tax involved.

Respectfully submitted,

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